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RECENT TRENDS IN U.S. DIRECT INVESTMENT IN JAPAN

Summary

The Japanese attitude toward direct foreign investment has undergone several transformations since the end of World War II. Foreign investors who thought the welcome mat was out have had it rudely yanked from under them the next moment. Official policy has been hostage to the changing needs of the economy as perceived by the government and business community. The demands of rebuilding a war-torn economy and setting infant industries on their feet while maintaining adequate foreign reserves shaped the foreign-exchange control laws -- the gospel for foreign investors. While these strictures were loosened in a series of steps beginning in 1967, and largely abandoned in the new foreign-exchange control law of 1980, direct foreign investment in Japan still lags behind that of other countries. As the Japanese government admits, more must be done to promote this activity if Japan is to continue to prosper in a capital-poor world.

The Role of Foreign Direct Investment

Foreign direct investment can play an important role in the development and growth of an economy not only by supplying a scarce resource -- capital -- but also by providing needed technology and labor skills. In addition, the establishment of economic ties can generate momentum leading to political cooperation as well as to broader economic interaction. But the investment is not without risks for the host country. While there are unambiguous gains in terms of employment, the benefits of increased output, technology transfer and

labor training may escape the country's grasp if the investment is not properly structured or operated. For a developing nation, foreign investment also poses problems in terms of monetary policy as repatriation of profits could loom large in its balance-of-payments and exchange-rate situation. Governments face the problem of how to balance the demands of foreign investors with national economic priorities in order to create conditions where each party's interests are protected.

Immediately after the war, foreign investment was welcomed but tightly controlled in Japan because the government placed a premium on defending the value of the yen and maintaining a healthy balance of payments. The need to allow repatriation of profits as an inducement for foreign investors clashed with the importance of foreign-exchange reserves for defending the value of the yen under the Bretton Woods system of fixed exchange rates. Thus, instead of supplying capital for reconstruction, foreign investment served Japan as a source of critical technology and managerial skills. This preference is borne out by the data. In 1951, 87.4 percent of all foreign investment in stocks went to companies that agreed to allow foreign participation in management. (This figure dropped to 9.3 percent by 1970.) The number of cases of technology licensing jumped from 27 in 1949-50 to 110 in 1951. Yet foreign investors were still held at arms length by the Japanese, who feared monetary headaches and unruly foreign-controlled companies if investment laws were liberalized.

As exchange problems eased and Japanese industry began to make forays into world markets, the positive role of foreign investment began to shrink even more drastically. From the viewpoint of government officials, it was a channel through which elephant-sized foreign companies could enter the Japanese market and trample pygmy domestic competitors. In retrospect, such fears were excessive even though this was a period of overseas expansion by American corporations. Foreign capital was seen as a threat if it meant giving overseas interests a significant position in domestic markets. On the other hand, if the foreign investor was willing to help raise an infant industry up to international competitive standards, the investment application stood a good chance of timely processing. Despite successive liberalizations of Japan's foreign-exchange and investment laws, inward direct investment carried negative connotations up until the start of this decade.

Necessity may have dictated the present admiration for overseas investors expressed by the Japanese. As the cost of research and development in high technology fields has skyrocketed, and congestion along the Tokyo-Osaka corridor has grown unbearable, foreign investment promotion in rural areas is emerging as a possible cure for these problems. While the flow of technology into and out of Japan is more balanced than before, Japanese firms are now confident enough to pursue cooperative research and cross-licensing with foreign rivals and willing to share equally in the benefits. Prefectural governors court foreign investors with an ardor equal to any state governor for identical reasons: jobs. The importance of this alternative will become increasingly valuable as the Japanese economy matures.

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The Flips and Flops of Foreign Direct Investment Laws

In 1949, the cabinet issued Japan's first postwar directive on foreign direct investment. Cabinet Order No. 51 took an extremely cautious attitude by failing to guarantee repatriation rights or the sanctity of foreign investments. In addition, many actions required the approval of the appropriate minister -- a clumsy process.

Realizing the weakness of this statute, the government modified it with new legislation that offered security guarantees to investors and broadened the bill's domain. The Foreign Investment Law enacted in May 1950 remains the basic vehicle for policy. Reflecting the extreme conditions facing the economy, the law established a system of prohibitions on external transactions with exceptions or relaxations possible only through cabinet actions. While the law did guarantee the right to the fruits of investment and provided safeguards against expropriation, there were numerous catches. Time-consuming ministerial approval was still required and the scope of activities requiring approval was widened. The real kicker was the limitations on how and when a foreign investor could move his profits out of Japan. Repatriation had to be spread out over a number of years in most cases. Moreover, the yen-denominated profits were usually not convertible into other currencies. Many companies did not see holding yen as a desirable condition and stayed out of Japan. Certain companies with long-standing Japanese operations received different treatment as their profits were convertible, though the timetable restrictions still applied.

Throughout the 1950s and early 1960s, the value of foreign direct investments grew steadily. Japan's membership in the International Monetary Fund (IMF) in 1952 and accession to the General Agreement on Tariffs and Trade (GATT) in 1955 led to some slight relaxations in administering the foreign-exchange and trade laws. In 1960, the government announced a plan to begin liberalizing import restrictions which increased the attractiveness of Japanese industry to foreigners.

Until 1964, the law was applied in a strict but not obstructionist manner, and many foreign companies, with Americans in the fore, decided that the long-term potential of the Japanese market justified the risks of a direct presence. In 1964, however, Japan was accepted as a member of the Organization for Economic Cooperation and Development (OECD) and was forced to make changes in its foreign-exchange policy that effectively removed bars to the yen's convertibility. The Japanese bureaucracy took upon itself the task of protecting what it perceived as a weak, fledgling economy from the onslaught of behemoth multinational corporations as they sought entry into attractive Japanese markets. The once warmly welcomed foreign investors suddenly found the Japanese giving them the cold shoulder -- fewer investment applications were approved and terms for technology licensing agreements became even more pro-Japanese. Between 1963 and 1964, the value of stock purchased by foreigners plummeted from $185 million to $85 million and the number of technology licensing agreements fell to 500 from 564. These figures fell again in 1965 before slowly inching up, though stock purchases did not regain their 1963 level even as late as 1967. The laws that required ministry approval for nearly all financial transactions became a suffocating tangle of bureaucratic red tape choking off many potential investors. Holders of key technologies

could still get a foot in the door (such as Texas Instruments), but such cases were few and far between.

While the Japanese were very proud of their OECD status, they were not ready to face up to the responsibilities in terms of liberalizing their financial regulations to conform with the organization's guidelines. In the words of a 1967 Bank of Tokyo manual on foreign-exchange practices, "The controls on payments related to investments and loans abroad and the like have not yet been liberalized to a larger extent than those on current invisible payments. The number of items (18 capital items), in which Japan now makes reservations in connections with the Liberalization Codes of the OECD, is still large compared with those of other members of the Organization." This situation persisted throughout the 1960s and 1970s, though in decreasing intensity as several waves of liberalization were carried out.

The re-opening of Japan's market to foreign direct investment that began in 1967 and lasted until 1980 was a slow and difficult process as Japan tried to transform its foreign investment laws from "basically restricted" to "basically free." The effect of the four liberalizations (July 1967, March 1969, September 1970 and August 1971) was to widen the conditions providing automatic validation for stock purchases and joint venture formation. The new measures also freed technology licensing agreements from restrictions relatively early in 1968. Yet for all the liberalization rhetoric, foreigners still felt there were barriers in their paths as they tried to enter the market. (The Japanese tacitly admitted as much by using the previous quotation in their foreign investment manuals as late as 1978.) Problems of transparency and information were often cited by investors as reasons for withdrawing applications. Certain companies and sectors were closed, and caps were placed on the degree of foreign ownership. Finally, repatriation of profits still required permission and was still regulated in terms of value and timing.

The 1980s got off to a good start when the Japanese revised the Foreign Exchange and Foreign Trade Control Law to make all transactions "free in principle." Of course, numerous restrictions were permissible under the new law, but the last real legal hurdle had fallen. Under the new law, the Finance Minister retains wide discretionary powers to regulate capital transactions if national interests are threatened. The onerous validation requirements have been eliminated (and replaced with a prior notification procedure) along with most restrictions on investment and repatriation of profits. Trade in services has also been freed, a point that will be increasingly important as the Japanese economy matures. Therefore, while Japan has liberalized its foreign investment laws significantly since 1950, the attitude that controls must exist and foreign direct investment must be monitored persists in the government, posing a psychological hurdle that is not quickly overcome.

Investment Promotion

In the forefront of the Japanese effort to attract foreign investors are local governments in rural areas. Because of declining employment opportunities and an end to the flow from rural to urban areas, local officials find themselves faced with a steadily worsening unemployment problem. In an era of austerity, the public works fountain dries up, stimulating other employment measures. The idea of generating jobs with foreign money is quite

unusual, especially coming from local governments, and a great deal of effort has been spent on public relations to get the word out that foreign investors are welcome. Industrial parks and infrastructure improvements have been established and local tax laws amended to create incentives for investors. Without the blessing of central authorities, however, few foreign companies have been willing to accept the local offers.

The central government has finally augmented local efforts by providing support services and introducing the "Technopolis" program. The Industrial Guidance Division of the Ministry of International Trade and Industry (MITI) has begun to provide foreign investors with information on sites and facilities that meet their investment needs. While it is difficult to convince foreigners that MITI is welcoming foreigners into Japanese markets, today the computerized English-language service can check over 2,200 sites for investment compatibility and tax incentives. Information is only the first level of assistance the central government offers. The Japan External Trade Organization (JETRO) now provides potential investors with consulting and translation services at its overseas offices (JETRO previously focused on promoting Japanese exports). A new office of investment promotion has been established as part of Japan's most recent market liberalization moves, making it even clearer that the government is serious about attracting foreign investors. The Japan Development Bank (JDB) has also announced that it will now provide loans to foreign companies wishing to start new enterprises in Japan.

Perhaps the most widely promoted new central government investment promotion plan is the "Technopolis" program. Targeting investment by domestic and foreign high technology companies, the government has approved nine regional development plans that coordinate infrastructure development with tax and financial incentives (five other areas are pending approval). MITI hopes to improve the performance of small- and medium-sized firms as well as disperse new industries more evenly around the country. The project involves local authorities who must meet MITI guidelines in terms of location, labor resources, educational facilities and infrastructure. In exchange, MITI provides information and consulting services as well as financial help through the JDB and Hokkaido-Tohoku Development Corp. Response to the program has been almost too effusive. It is unclear whether or not Japan can support dozens of top-notch biotechnology or electronics firms -- the education system may not be able to supply the skilled labor. Whether so many firms can establish themselves in Japan's market is also a nagging question given the tightly linked nature of the distribution and marketing systems. Enthusiasm remains high, however, and most of the new ventures should make a good go of things.

An Investment Comparison: 1982 vs 1983

Aggregate inward data exist for fiscal years 1982 and 1983 showing a significant increase both in value and in number of cases. In FY 1982 there were 1,074 foreign investments with a total value of $749 million (the figures include stock purchases, bond issues, technology licensing contracts and portfolio investments). In FY 1983 the number rose 2.6 times to 2,363 cases while the total value of investments went up 8.5 percent to $813 million, a new record. There was also an upsurge of 20 percent in the number of foreign affiliates establishing factories on plots 1,000 square meters or larger in FY

1983; over one-third of the new plants will produce high technology products. According to a MITI survey, many medium-sized and smaller firms have taken the plunge into the Japanese market, a clear signal of the improved investment climate.

Focusing on major purchases of stock in calendar years 1982 and 1983, some interesting trends are evident. In overall terms there were 476 cases of major (greater than Y100,000 or $435 at current exchange rates) stock purchases adding up to Y113,821 million ($495 million) in 1982. These figures rose to 639 cases and Y119,424 million ($519 million) in 1983. Sorting the purchases by type (participation in new enterprises, participation in existing enterprises and expanded participation in existing enterprises), there was only a slight increase in the value of new ventures (3.8 percent or $10 million), but a large increase in the number of new ventures (321 versus 241). Investment in existing firms plummeted in value from Y45 billion ($197 million) to just under Y10 billion ($42 million), but rose in frequency to 185 from 129, translating into an average decrease in value per investment from Y351 million ($1.5 million) to Y53 million ($229,000). The decline in this category was balanced by a large rise in both the value of expanded existing holdings of Y39 billion ($169 million) and the frequency (133, up from 1982's 106). Individual investors play a larger role than might be expected, accounting for almost 20 percent of the number of all major stock purchases and 1.6 percent of the total value. Investments by existing foreign subsidiaries also play an important role, showing that foreign companies in Japan are committed to remaining in the Japanese market and are aggressively pursuing an expanded presence.

Country data are presented in Tables 1 and 2. It is obvious that the United States continues to be the major source of foreign investment in Japan with a 30 percent-plus share. Behind the United States, Hong Kong, the United Kingdom and West Germany are all closely grouped, with shares ranging from 3 to 8 percent. Most interesting is the fact that investment from Middle Eastern countries is so low, just 1.3 percent of the total and less than 0.1 percent of the value of all major purchases in 1982, and a mere 0.9 percent and 0.2 percent respectively in 1983. This is one group of countries where Japanese investment promotion efforts could pay off handsomely.

The United States leads in each of the three types of stock purchases. Tables 1 and 2 show the major European countries are less adventurous than their American competitors, preferring investments in existing Japanese enterprises or an expansion of their present holdings. The reverse appears to be true for Asian countries, probably because of their recent appearance as foreign investors.

Data on investment by type of business show a clustering around the export/import field as well as a growing emphasis on high technology. Machine tools and electronic equipment are popular with an increasing number of computer-related firms entering Japan. Much of the investment in the chemical sector is in pharmaceutical production or marketing, as offshore firms try to crack the lucrative Japanese market. Closer analysis of foreign entries into the more mundane industries such as food products or apparel show a strategy based on supplying products that are of high quality or distinctly foreign in character. Finally, investments in the service sector provide consulting, management, marketing or design operations to a wide range of businesses,

presumably putting them in head-to-head competition with the established Japanese trading companies.

Several industries are notable for their lack of appeal to foreigners: construction, glass and stone manufacturing, transportation, warehousing and wholesaling. For the most part these are industries where foreigners do not provide significantly superior products. Moreover, they are slow growing markets with plenty of entrenched domestic competition. While market liberalization will increase opportunities in some fields, such as tobacco wholesaling and distribution, foreign investors will find it difficult to establish new firms in many industries because of business practices that emphasize long-term relations and loyalty between buyers and sellers. Joint ventures and investment in existing companies offer ways around this problem and the method may gain popularity as the investment climate becomes more hospitable.

U.S. Patterns of Investment

The structure and purpose of American investments point to a pattern of investment strategies based upon the field of entry. In general, high technology firms providing established goods or services opt for the creation of a majority (often wholly) owned subsidiary to produce for or service the Japanese market in the near-term and the Asian market in the future. This group includes Xidex Corp. (a maker of floppy disks and computer peripherals), Corning Glass Works, Life Technologies Inc. (tissue culture apparatus) and Inductotherm Industries Inc. (a producer of electric induction furnaces). High technology firms involved in costly research and development programs seek Japanese partners for joint ventures, cross licensing, production and marketing agreements. International Business Machines Corp. (IBM), Merck Pharmaceutical and Remote Technology Corp. are typical of this group.

Vendors of unique products usually set up their own marketing and distribution subsidiary. Apple Computer Inc., Digital Research Inc., CPT Corp., American Components Inc. and others have taken this go-it-alone route. Some smaller firms also chose this risky path, among them Esprit de Corp. (an apparel maker) and some individual businessmen -- J.V. Elliot, operator of a livestock feed business, and Lou Dapas, a vendor of gas masks and other industrial safety equipment. Joint ventures are also a popular alternative for unusual products, particularly electric and electronic components and photographic equipment.

Buying into established firms in the same or related field is a desirable strategy for many American firms seeking a toehold in Japan. Some problems exist with this method, however, since a Japanese firm that is receptive to foreign offers is often in trouble. Merck Pharmaceutical's buyout of foundering Banyu Pharmaceutical is the most publicized example. Smaller Japanese firms are receptive to this strategy because in a fiercely competitive market, tie-ups of this nature provide access to American products. At the same time, they offer Americans well-established Japanese contacts. This path also serves giants like General Motors Corp. (GM), which is seeking a solution in manufacturing competitively priced subcompact cars. GM's links with Isuzu Motors, Ltd. and Suzuki Motors, Ltd. form the basis of a good relationship in the fiercely competitive auto industry.

Joint ventures, which were once the preferred mode of investment, have lost much of their sheen in recent years. Many American partners are either selling their shares or buying out their Japanese partners in an effort to put things back on track. Much of the problem seems to stem from management incompatibility. The Japanese system of decision-making by consensus is famously time consuming and American companies have found it very frustrating. On the other hand, Japanese companies are usually cautious in their dealings with foreign partners because they do not completely trust the alliance and thus never allow a solid relationship to develop -- a catch-22 situation. Sobered by their peers' experiences, many companies on both sides of the Pacific are negotiating joint ventures with more realistic expectations -- a good sign for future success.

The services industry is in a state of rapid development, favoring foreign firms which have an edge in experience. Wholly owned subsidiaries or majority owned ventures seem to be the most popular vehicles. The wholly owned route is favored by many software firms or computer consulting services, including Microsoft Inc., General Electric Co. and Magicsoft Corp. Vendors of management services often establish a joint venture with a large Japanese company linked to numerous business partners. Financial service companies are planting seeds in the rich Japanese market and as liberalization of this market proceeds over the coming years, ample harvests can be expected.

While companies anxious to do business in Japan constitute the majority of international traders, portfolio investors and pure investors are also numerous. With the meteoric rise of the Tokyo Dow Jones average powered by very strong gains in corporate profits, foreign individual and institutional investors are looking more and more often at Japan to diversify their holdings and increase their return. This movement has not escaped the attention of American financial institutions which also have an eye on Japanese pension funds and are seeking government permission to engage in trust operations in Japan -- a sore point between the two countries. Foreign bond issues by Japanese companies are becoming increasingly popular, and an explosion in the Euroyen market is expected with the liberalization of regulations allowing over 100 Japanese companies and institutions to issue bonds on international markets.

Therefore, a pattern of building upon company strengths or seeking partners to shore up weak areas seems to emerge from the data on American investment in Japan. What is encouraging is the fact that many U.S. firms are going into Japan with their own subsidiary and challenging the Japanese head-on. While this speaks well of American entrepreneurial spirit, it also indicates the change in Japan's attitudes toward foreign investors.

The Outlook for 1984 and Beyond

Investment data from the Ministry of Finance for the first two months of 1984 point to continued strong interest by foreign investors. In January there were 138 cases reported with a value of $27 million; February hit a record 256 with a total value of $26 million. The average for 1984 per month is well above 1983's 157 and far above 1982's average of 80. With the stock market booming and the economy picking up, Japanese investments will become increasingly attractive and 1984 may well prove to be another record year.

Subsidiary diversification and establishment of more wholly owned subsidiaries is likely to continue with renewed vigor. New trends are in the making, given financial market liberalization,the telecommunications deregulation and the Technopolis program. High technology companies, including biotechnology specialists, software developers and advanced materials producers, will continue to receive a warm reception as Japan restructures its economy. The rapidly expanding services industry should also prove to be fertile ground for American companies. The process of diversification by particular Japanese industries also offers opportunities for cooperation. The petrochemical industry's moves into biotechnology and specialty chemicals offer many U.S. firms potential partners for joint R&D ventures. The same is true for other industries facing stagnant markets or stiff foreign competition: steel, textiles, etc. Many prosperous Japanese firms are also moving into new areas and may seek foreign partners for expertise and readily available products.

Successful investment in Japan is still not an easy task, however. The competition for labor and markets is very severe. While few legal barriers remain, many bureaucratic and cultural restrictions exist. Japanese companies are willing to put up with foreign competitors in their own market; they are probably unhappy that the government is now promoting such competition. The perception that the Japanese economy somehow needs protection from foreign invaders is still strong within the lower levels of the bureaucracy. As foreign firms in Japan prove their loyalty and commitment to Japanese customers, this attitude may begin to abate. The process, however, will be long and trying.

For further information contact Jon Choy.

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Table 1: Major Direct Foreign Investments in Japan by Country and Category, 1982*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y61,939.5 (54.4%)	176 (37.0%)	Y56,640.4 (93.0%)	93 (38.6%)	Y1,236.8 (2.7%)	42 (32.6%)	Y4,062.4 (53.8%)	41 (38.7%)
Canada, Central & South America	929.1 (0.8)	21 (4.4)	359.5 (0.6)	11 (4.6)	40.5 (0.1)	4 (3.1)	529.1 (7.0)	6 (5.7)
United Kingdom	7,297.1 (6.4)	37 (7.8)	819.3 (1.3)	20 (8.3)	6,140.0 (13.5)	10 (7.8)	337.7 (4.5)	7 (6.6)
West Germany	900.5 (0.8)	32 (6.7)	268.5 (0.4)	20 (8.3)	549.9 (1.2)	6 (4.7)	82.1 (1.1)	6 (5.7)
France	1,090.6 (1.0)	23 (4.8)	92.0 (0.2)	9 (3.7)	812.7 (1.8)	6 (4.7)	185.8 (2.5)	8 (7.5)
Other Europe	2,823.1 (2.5)	80 (16.8)	1,178.5 (1.9)	39 (16.2)	422.5 (0.9)	24 (18.6)	1,222.1 (16.2)	17 (16.0)
Hong Kong	1,748.8 (1.5)	36 (7.6)	320.9 (0.5)	11 (4.6)	922.2 (2.0)	17 (13.2)	505.8 (6.7)	8 (7.5)
Taiwan	829.6 (0.7)	24 (5.0)	671.0 (1.1)	11 (4.6)	98.7 (0.2)	8 (6.2)	59.9 (0.8)	5 (4.7)
Korea	12.0 (**)	1 (0.2)	12.0 (**)	1.0 (0.4)	0.0	0	0.0	0
Southeast Asia	445.7 (0.4)	14 (2.9)	21.2 (**)	8 (3.3)	50.5 (0.1)	4 (3.1)	374.0 (5.0)	2 (1.9)
Other Asia	25,722.4 (22.6)	23 (4.8)	517.3 (0.8)	13 (5.4)	25,022.1 (55.2)	6 (4.7)	183.0 (2.4)	4 (3.8)
Africa	46.7 (**)	3 (0.6)	0.6 (**)	1 (0.4)	41.4 (0.1)	1 (0.8)	4.7 (0.1)	1 (0.9)
Middle East	36.0 (**)	6 (1.3)	31.0 (0.1)	4 (1.7)	5.0 (**)	1 (0.8)	** (**)	1 (0.9)
Total	113,821.0	476	60,932.1	241	45,342.4	129	7,546.5	106
Of Which:								
Individuals	1,130.9 (1.0)	84 (17.6)	786.7 (1.3)	39 (16.2)	218.3 (0.5)	33 (25.6)	125.9 (1.7)	12 (11.3)
Subsidiaries	47,462.9 (41.7)	34 (7.1)	43,468.1 (71.3)	17 (7.1)	189.2 (0.4)	5 (3.9)	3,805.5 (50.4)	12 (11.3)

* Stock purchases with a value greater than Y100,000 only.
** Less than 0.1

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.